

House of Representatives Committee on Small Business
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“A Hearing to Consider Legislation Updating and Improving the SBA’s Investment and Surety Bond programs”

Testimony of:
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Final

Introduction

Chairwoman Velazquez, Ranking Member Chabot, and members of the Committee, my name is Bob More and I am a partner at Domain Associates, a venture capital firm with offices in Princeton, New Jersey and San Diego, California. I am also a member of the National Venture Capital Association based in Arlington, Virginia. My views today represent 460 member firms which currently comprise approximately 90 percent of all the venture capital under management in the United States.

Domain Associates invests exclusively in young life science focused businesses with outstanding growth potential. Our three major investment segments are pharmaceuticals, specialty pharmaceuticals, and medical devices, while additional areas of interest include biomaterials, bioinstrumentation, and diagnostics. The partners of Domain have been involved in the formation and growth of more than 190 life-sciences companies. We typically prefer to be a part of the first institutional financing round of the company and look for companies with outstanding technology addressing unmet needs in very large markets. Once invested, in the vast majority of cases, Domain will take a seat on the Board of Directors and work closely with other members of the Board and management to guide the growth of the business.

I would like to thank the Committee for the opportunity to share with you today the challenges that our small venture backed businesses have faced recently as it relates to current SBA policies and why we believe the Small Business Investment Expansion Act of 2007 is a positive step towards mitigating these challenges and fostering the type of

private/public partnership that will allow the United States to sustain its economic leadership for years to come. To date much of the Congressional debate around SBA's policies and interpretations have focused on the details and nuances of each particular issue. On behalf of the venture capital community, we think it is important to take a step back and for you, the Congress, to ask what can be done to best support the creation and development of small businesses in the United States. We believe partnerships between government and the venture capital community have and will continue to be one of these winning strategies.

Venture Capital Investment Overview

I would like to briefly explain how the venture capital industry creates and grows small businesses. Typically venture firms raise their funds of money from institutional investors such as pension funds, endowments and foundations with the charter to invest those funds in promising young start up companies. Once a fund is raised, we look for the best and brightest entrepreneurs in which to invest, usually within a specific industry sector in which we have an expertise. Venture capitalists most often look for companies that are innovating in a significant way. For this reason, we are often associated with high technology or life sciences businesses. We often find these entrepreneurs in university and government labs, through others who are already in our network, or we work with entrepreneurs who we have successfully funded in the past.

In order to be considered for venture capital investment, the entrepreneur typically has a product or service that has gone through the discovery process and is ready to be clinically tested and commercialized. We stay invested in these companies – both financially and through the sweat equity we offer – for anywhere from 7-10 years, often longer and rarely less. The ultimate goal is to build the business until it can go public or become acquired, generating a return for our institutional investors. In 2006, the venture capital industry invested \$26.3 billion into more than 3500 deals in the United States.

Venture Backed Companies Drive US Economic Growth

Venture capital investment has remained at a consistent level during the last five years during which time the United States economy has been facing new challenges. Since early 2000, we have faced the off-shoring of highly skilled jobs and the consolidation of older industries, all at a time when developing nations such as China and India are building up their infrastructures and ecosystems to become more formidable competitors. We all agree that to continue our global leadership, the United States must foster an ongoing environment where new companies continue to grow, innovate, and create jobs here.

The federal government has called on the private sector to help meet this challenge. The venture capital community has responded and backed thousands of small businesses which have played a critical role in developing new industry sectors, creating highly skilled US jobs, generating more revenues, and bringing innovative products and services to the US market. According to the econometrics firm Global Insight, in 2006, venture backed companies accounted for 10.1 million jobs and \$2.3 trillion in US revenues, equating to 9 percent of US private sector employment and 18 percent of US GDP. Companies that were once small venture backed businesses include: Google, Genentech, Intel, Cisco, Starbucks, Microsoft and Federal Express. Today, I am here on behalf of the next Google or Genentech that is currently being funded by a venture capital firm and because of this, is significantly disadvantaged by current SBA policies.

Current SBA Policies Hurt Venture Backed Companies and the Economy

Since 2001, a change in the interpretation of policy at the Small Business Administration (SBA) has run in direct opposition to the premise that venture backed businesses are one of the most promising vehicles driving US economic leadership and should be supported wherever possible. Specifically, we are troubled by the SBA's recent interpretation of its affiliation rule in determining whether a business entity meets the small business criteria of having less than 500 employees. Under the existing affiliation requirements, a business concern can have no more than 500 employees, including its affiliates to qualify as a small business. Under this requirement as it was historically applied, most venture backed businesses would meet the

criteria. Our companies are very small, especially in their early years. However, SBA has recently applied a formula which sweeps in the venture capital firm AND the employees from every company in which the venture capital invests when considering a venture backed company for small business classification. They have applied this formula even though the company in question has absolutely no relationship to the other companies and their employees. Unfortunately, I have been involved in one of these instances over the past year.

Case Study

Approximately nine months ago, one of my firm's small, developmental stage portfolio companies, which is working to develop a new specialty pharma product, filed a new drug application (NDA) with the Food and Drug Administration, requesting a small business waiver for the FDA's fee for reviewing the application. The fee was approximately \$900,000. The FDA's fee waiver program is intended to benefit small businesses, exactly like our portfolio company. Section 740(d)(1)(A) of the FD&C Act provides that the FDA shall grant a waiver for or a reduction of one or more of the fees where the FDA finds that: *"the assessment of the fee would present a significant barrier to innovation because of limited resources available to such person or other circumstances."*

In order to qualify for a fee waiver, a company must have fewer than 500 employees, including employees of all affiliates. An "affiliate" is defined as a business entity that controls or has the power to control another entity.

The FDA requested that the SBA conduct a formal size determination with respect to the Company's eligibility for the waiver of the fee. In February, the Company filed the appropriate paperwork with the SBA. The paperwork showed that the Company has never had any revenues and, that during the three-year period prior to the filing of the NDA, the Company averaged 7.25 employees. Given that this level was well below the 500 employee threshold, the Company assumed that it would be eligible for the waiver.

Little did the Company know that we were about to begin quite an adventure with the SBA. A month after the appropriate forms were filed, the SBA notified the Company that it had determined that Domain controls the Company. They requested information with respect to Domain's ownership interest in all of its other unrelated portfolio companies, so that the SBA could determine if Domain also controlled those companies. If Domain was deemed to control any of the other companies, they would be deemed to be "affiliates" of the Company. The SBA also requested information with respect to the number of employees at Domain's other portfolio companies.

The SBA concluded that Domain controls the Company because it has a 34 percent ownership interest in the Company and it is the single largest shareholder. The Company and its counsel explained to the SBA that Domain only has the right to elect one out of six Directors and that neither Domain nor any of the three other venture capital firms invested have the ability to unilaterally exercise either affirmative or negative control over the Company. The Company and its counsel further explained that Domain may be the single largest shareholder, but as a practical matter, Domain does not control or have the ability to control the Company.

In response to this explanation, the size specialist at the SBA responded by saying, "that may be true, but the SBA does not deal in the real world." The size specialist continued to insist that Domain provide information with respect to its other portfolio companies and Domain's Controller spent countless hours obtaining and providing such information. It should be noted that Domain's other portfolio companies also spent a significant amount of time providing the information relating to the ownership of such companies and the number of individuals employed by each.

At this point, the time it was taking for the determination, and the uncertainty of the situation, was becoming significantly problematic from a market standpoint. In order not to jeopardize its NDA, the Company paid the \$900,000 filing fee to the FDA and has now requested a refund, if the SBA ultimately finds that it qualifies for classification as a small business. This is a sum of money that would otherwise be directed towards the Company's growth through additional research, hiring of key management, or market development.

The Company and its counsel have provided the SBA with information and facts that clearly establish that Domain is not an affiliate of and does not control or have the ability to control the Company. The Company, which presently has eight employees, clearly qualifies for classification as a small business. Earlier this week, the Company was advised by the SBA that, after more than seven months since the FDA requested that the SBA conduct the size determination, the SBA is still working on the matter. This process has clearly harmed the kind of small business that the SBA was established to help. My understanding is that we are not alone in this predicament and that the SBA is using this flawed reasoning with other venture backed companies. It is clear "the SBA does *not* deal in the real world" and, by its actions, is presenting a significant barrier to innovation.

On the technical merits it is difficult to understand how the SBA justifies their position when it directly contradicts language in the Small Business Investment Act which seems to address this very issue. Section 103 of the SBIA states that an investment by a venture capital firm:

(A) shall not cause a business concern to be deemed not independently owned and operated regardless of the allocation of control during the investment period under any investment agreement between the business concern and the entity making the investment;

(B) shall be disregarded in determining whether a business concern satisfies size standards established pursuant to section 3(a)(2) of the small business act

From this language it seems clear that ownership by a venture capital firm would not trigger the Affiliation Rule for programs that were created under the SBIA. Furthermore interpretation by the SBA to the contrary runs in direct opposition to the intent by Congress to encourage venture capital funding of small businesses.

SBA's Misperceptions

It appears that the SBA has the gross misperception that small businesses that receive venture backing should not be considered a "small business" and do not need to compete for small business grants, contracts or even get small business waivers. If they have already received venture capital funding, why do they need government dollars? The answer lies in the investment model that venture capitalists have used for decades. Our industry is focused on building companies that will commercialize their product or service. We typically enter an investment when the early stage research has been completed and a hypothesis has been proven. Therefore, a small business must leverage other sources of financing to bring research to the stage where it can be commercialized by a venture capitalist. Often a venture capitalist is funding one product while the company is building a pipeline of new products through basic research. The new products often require non-VC funding sources such as the SBA or an SBIR grant. Without this funding, many innovative technologies would linger "on the shelf" because they would not reach the stage where they could be brought to a venture capitalist and subsequently commercialized.

Intuitively, it would seem that the SBA would want to fund venture backed companies because these companies have already been vetted by professionals who think highly enough of the management team to invest. Unfortunately, this is not the case. The current interpretation by SBA could be likened to a situation in which the NIH would refrain from funding any project at a well endowed academic institution because they already have money behind them. Clearly, this is not the case with the NIH because the reasoning behind such a premise is fatally flawed. So too is the SBA interpretation of venture backed companies. These companies have just as great a need as non-venture backed entities – and are probably better positioned to succeed. So

while Congress and the Administration are doing all that they can to promote job growth and innovation, the SBA policies have ironically been stifling it.

This issue of the SBA discriminating against venture backed companies is not limited to the affiliation rule. We are facing similar issues when applying for Small Business Innovative Research (SBIR) grants. Here the SBA has used VC ownership as a reason not to grant basic research funds to our companies that have very promising projects waiting for funding. Though not the focus of today's discussion, it is worthy of mentioning because it demonstrates a pattern of animosity of the SBA towards venture backed companies and it too needs to be fixed.

Support for Legislation

NVCA supports the Chairwoman's efforts in crafting the Small Business Investment Expansion Act that will provide incentives for venture capital firms to invest in small businesses nationwide and promote entrepreneurship which is critical to creating jobs and discovering new innovations in this country. We specifically support Title V of the legislation which will resolve the SBA's affiliation issue and which will clarify SBA's affiliation rules by ensuring that businesses with venture capital investment are not penalized for a venture capital firm's additional investment in other portfolio companies that have no relationship to one another.

Title V of the legislation will amend Section 3(a) (1) of the Small Business Act clarifying that for the purposes of determining whether a small business concern is less than 500 employees and is independently owned and operated, the SBA shall not consider a small business concern that has received investment by a venture capital operating company to be affiliated with either the venture capital operating company or any other business in which the venture capital operating company invests. It will also put in place proper safeguards to ensure that this provision cannot be exploited by large businesses by specifically defining a venture capital operating company.

Conclusion

Current and past Administrations have recognized the important contribution of venture capital investment in fostering innovation but SBA's policies continue to contradict these incentives. Over the years, current and past Administrations have focused on marshalling the economic resources to help spur innovation and develop programs that would provide incentives to foster public-private partnerships to further the country's economic goals. The American Competitiveness Initiatives, the Department of Defense-Defense Venture Catalyst Initiative, In-Q-Tel and DARPA (Defense Advanced Research Projects Agency) are a few examples of these types of programs. But the SBA's policies have and will continue to have a chilling affect on the federal government's ability to leverage the most promising small businesses in the country.

No other asset class supports the premise more that small businesses are the life blood of the US economy than venture capital. As investors in these important entities, we are advocates for their viability and growth. We are not sure what world the SBA operates in, but in our world all of these small businesses should all have access to the same benefits, because they are all promising entities that are promoting job growth and innovation. The actions of the SBA are doing nothing but stifling this process which has been so beneficial to the US economy for so long. We are confident that the proposed legislation is a positive step in keeping us all in the real world and assuring that the United States maintains its competitive edge by supporting small businesses of all kinds.

Thank you.